MEMORANDUM — HOUSE FISCAL AGENCY

DATE: June 30, 2005

TO: Members of the Michigan House of Representatives

FROM: Mitchell E. Bean, Director

RE: Securitization of Tobacco Settlement Revenue

This memo, provided to you at the direction of Speaker DeRoche, explains the process various state and local governments have used to securitize tobacco settlement revenue. It also summarize conversations with Citigroup and Behr-Sterns.

Background

Securitization is the process a state uses to sell the revenue stream of its tobacco settlement payments. A state sells payments for a defined number of years, in return for a single up-front payment. The value of the up-front payment is less than the sum of the annual payments; however, one large payment allows the flexibility of establishing an endowment or applying the sum to a major program. Securitization is comparable to a lottery winner accepting an up-front payment in lieu of a 20-year annuity.

States were initially attracted to securitization because of the perceived financial risk in the Master Settlement Agreement (MSA). There was concern that the MSA payments would bankrupt the major tobacco companies and prevent them from making the annual payments. By securitizing, states transfer the risk of those payments to bondholders.

Securitization has also been used by some states to obtain a critical mass of funds in order to initiate a major project or program. In addition, during the recent economic downturns some states used securitization of tobacco settlement revenue (TSR) to address revenue shortfalls and avoid cuts to education and health and human service programs.

The TSR bonds are sold like any other state capital improvement bond offering through an already-existing or newly-established quasi-state agency. This provides a firewall between the bondholders and the state's general fund. If the tobacco companies were to go bankrupt and default on the MSA payments, the state's general fund could not be used to pay off the tobacco bondholders. Although the MSA insulates tobacco companies from additional government litigation, the industry still faces the threat of lawsuits by individuals and groups (i.e., class action suits). Securitization of future payments protects states from the possibility that these lawsuits will bankrupt one or more tobacco companies.

Distribution Formula

In the MSA, the amount of money each state was awarded was based on a formula established by the state attorneys general that considered the number of smokers in a state and the amount spent on tobacco-related Medicaid expenditures. The MSA binds the tobacco companies to paying settlement money through the year 2025, at which point a new agreement would need to be negotiated. Between 2001 and 2025, the tobacco industry will pay the states approximately $206 billion. Michigan's share from 2000 to 2025 is approximately $8.5 billion; Michigan's share from 2006 to 2025 is approximately $6.5 billion.

Volume Adjustment

The annual payments are subject to a number of adjustments, reductions, and offsets, of which the most important is the volume-of-sales adjustment clause. That adjustment ties payments to nationwide cigarette sales, much like a sales tax. If, as anticipated by public health officials, cigarette consumption declines as a result of higher prices or anti-smoking initiatives, the annual payments will be reduced proportionately. Starting with the April 2000 installment, payments to the states are adjusted according to the number of cigarettes shipped in the United States in 1998 and 1999. For every full percentage point shipments decrease, payments will be decreased by 0.98 percent.

Citigroup has worked on approximately 40 percent of all state and local securitization issuances and, after analyzing Michigan's situation, believes that because the current climate for these instruments is good, Michigan could get a discount rate of 5.3 percent. That rate compares to much less competitive rates states got a few years ago when the market for these instruments was essentially flooded. Citigroup's suggestion was that if Michigan was going to securitize its TSR, it should move quickly.

In Citigroup's estimation, Michigan would receive approximately $4 billion if the entire amount through 2025 were securitized. After 2025, the stream of revenue from the MSA would revert back to Michigan—barring unexpected complications.

It should be noted that there are expenses associated with securitization. Expenses include:

Original Issue Discount (OID)

A non-governmental bond is normally issued so that the face or par value is paid to the borrower when the bond matures. The OID is the amount that the bonds are expected to sell below their par or face value. This provides an implicit interest payment that is added to the stated interest rate. Typically, bonds sell at a discount when their stated or coupon rate of interest is less than the market rate for that type of bond at the date of issuance. In extreme cases, there are zero coupon bonds which pay no interest, and therefore are sold far below their par or face value, so that the interest payment occurs in the form of a capital gain when the face amount is received at the maturity date. The OID is assumed to be slightly more than 3 percent of par or face value. It is a function of what the actual or state rate of interest is compared to the market rate at date of issuance.

Cost of Issuance(COI) and Underwriter's Discount

This refers to the difference between what the underwriter pays to the authority issuing the securities and the public offering price. This difference compensates the underwriter for filing fees, legal fees and other costs needed to sell securities on a public stock exchange. Citigroup estimates these costs to be approximately 1 percent of the face or par value of the bonds.

Liquidity Reserve
This amount of the bond proceeds is retained by the Underwriter as security for the bonds, in case the entire issue does not sell. The Underwriter will have the right to retain this reserve until the bonds are retired, as security in the event the tobacco revenue stream is insufficient to make scheduled interest and principal payments. This amount is estimated at 10 percent of par value.

Capitalized Interest
This refers to the accrued interest owed from the time the bonds are issued until the bond proceeds are available to make the first interest payments. This amount is estimated to be 2.5 percent of the gross proceeds after the discount.

Operating expenses
These are incurred by the bond broker and include expenses such as record keeping and marketing. This is typically a flat fee regardless of the face value issued.

These five expense elements are deducted from the gross bond proceeds to arrive at net bond proceeds.

The discount rate may also be affected by the use of the proceeds and whether or not bonds are taxable or tax exempt under IRS regulations.

If you would like a more detailed explanation, please let me know.

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